Federal Tax Implications of Divorce Decrees and Settlements

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It is customary for the parties to a divorce to view the event through eyes more perceptive of the financial aspects than are those of the about-to-be-married. The circumstances, especially where the parties are well-to-do, take on a considerable resemblance to a business transaction and as is usually true of most modern business negotiations, the impact of the Internal Revenue Code becomes the tax tail wagging the business dog. Important as the tax considerations are, however, they should never be permitted to take precedence over the practical considerations which determine what may be a desirable financial arrangement for the parties to a divorce or separation, or for the children of the marriage. Whenever, therefore, this article recommends one method of settlement as opposed to another, it must be understood that such conditions are in every instance conditioned on the premise that after factors other than taxation have been taken into account, the parties are still free to choose among the alternatives suggested. It should also be said by way of preface that this article has been written from the point of view of the advisors to the parties and does not attempt to consider the sociological or fiscal implications of the existing law with which the advisor must deal. Attention has therefore been directed to the problem of selecting the course of action, among those available under the law, which will minimize the tax effects to the parties, thus leaving more funds available for the purposes of the settlement to be negotiated. In this connection it should be noted that it has been assumed, because that is usually the case, that it is the husband who is to provide the funds rather than the wife, and that his income is taxed in a higher bracket than is hers, so that it is desirable to devise a plan which will shift the income tax burden to her where possible, negotiating the dollar amounts on the premise that it is the wife who will pay the tax in such cases.

In the simplest type of situation, the tax problem is of course not difficult. Where the only provision made for the support of a divorced wife is a decree requiring the husband to make periodic payments for the wife's support for an indefinite period, the payments are income to the wife under section 22(k) of the Internal Revenue Code, and are deductible by the husband under section 23(n). No gift or estate

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tax problems are involved at all. Payments decreed by the court to be made for the support of children, on the other hand, are not deductible by the father and are correspondingly not taxed as income either to the child or, if paid to her for the children's benefit, to the wife.

Where larger amounts are at stake, however, counsel for the parties do not usually submit the matter to the decision of the trial court; all arrangements are customarily made by a settlement agreement, which may or may not be incorporated in the decree which the court actually renders. The use of an agreement naturally permits much greater flexibility, since the parties are not limited by the statutory jurisdiction of the court, and have at their disposal a wide variety of possible combinations of alimony provisions, lump-sum payments, installment payments, sliding-scale provisions, trust, insurance and security arrangements, which may be tailored to suit the needs—and the tax brackets—of the parties. The lawyer who makes use of these devices must, however, watch their tax implications closely for it is agreements of this kind that have given rise to tax litigation—sometimes with unfortunate results. And since the provisions of the Internal Revenue Code with respect to alimony deductions did not appear in it until the enactment of the Revenue Act of 1942, many questions of interpretation are yet to be settled and some interpretations already handed down by the courts cannot be considered as final. The cautious practitioner therefore bears in mind that the tax advice which he sows today may be reaped, several years hence, in what may be less favorable weather for the taxpayer.

While the gift and estate tax must as well be taken into account, it is the income taxes which present the most obvious problems and a clear understanding of the basic provisions of the statute are of course a prerequisite. While, as noted above, sections 22 (k) and 23 (n) both deal with the subject—one with inclusion of the payments in the wife's income, the other with deductions from that of the husband—the latter section is little more than a cross reference to the former; it is section 22 (k) which embodies the provisions whose interpretation concerns us. In addition, consideration must be given to section 171, which deals with so-called "alimony trusts." Section 22 (k) provides as follows:

> Alimony, Etc., Income. — In the case of a wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, periodic payments (whether or not made at regular intervals) received subsequent to such decree in discharge of, or attributable to property transferred (in trust or otherwise) in discharge of a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation shall be includible in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includible in the gross

> income of such husband. This subsection shall not apply to that part of any such periodic payment which the terms of the decree or written instrument fix, in terms of an amount of money or a portion of the payment, as a sum which is payable for the support of minor children of such husband. In case any such periodic payment is less than the amount specified in the decree or written instrument, for the purpose of applying the preceding sentence, such payment, to the extent of such sum payable for such support, shall be considered a payment for such support. Installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument shall not be considered periodic payments for the purposes of this subsection; except that an installment payment shall be considered a periodic payment for the purposes of this subsection if such principle sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument, but only to the extent that such installment payment for the taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) does not exceed 10 per centum of such principal sum. For the purposes of the preceding sentence, the portion of a payment of the principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be considered an installment payment for the taxable year in which it is received. (In cases where such periodic payments are attributable to property of an estate or property held in trust, see section 171 (b)).

The somewhat involved language of this provision is confusing to the uninitiated until it is separated into its component parts. In order to be deductible, the payments must meet a number of requirements:

> (1) The wife must be divorced or legally separated from her husband under a decree of divorce or separate maintenance.

It has been ruled by the Bureau of Internal Revenue that annulment is not a divorce for purposes of this section.[1] A California interlocutory decree is a divorce, however.[2] And the fact that the validity of a divorce may not be recognized in the state of domicile is apparently irrelevant, since deduction has been allowed in the case of Connecticut residents who were divorced in Mexico, even though a new decreee had later been obtained in Nevada upon advice of council that the Mexican decree would not be recognized in Connecticut.[3]

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[1] Bureau Letter, December 8, 1944, reported at 454 CCH 9602.

[2] I. T. 3761, 1945 Cum. Bull. 76.

[3] G. C. M. 25250, 1947-2 Cum. Bull. 32.

(2) The payments must be periodic payments.

The statute does not contain a complete definition of the term "periodic payments," but it does provide that certain installment payments are not to be considered as "periodic payments." It may be assumed, however, that a single lump-sum payment is clearly not periodic. What if the decree or agreement provides for payment of a lump sum in a series of installments? Are the installments "periodic payments?" Section 22 (k) provides an arbitrary answer: if the principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than ten years from the date of the decree or instrument, the installments are considered periodic payments; otherwise they are not. It should be noted, however, that payments which are to be made in a period of ten years or less are excluded from the definition of periodic payments only if they are installments on a principal sum specified, in terms of money or property, in the decree. It is not necessary, of course, that the principal sum be identified as such in the decree or instrument. For example, a provision requiring payment of $100 a month until $9500 has been paid,[4] or payment of $100 per month for 50 months,[5] is considered a provision specifying the principal sum. The same is true even if the payments are subject to being cut off by a contingency, so that, for example, a provision requiring payments of $125 per week for two years or until the wife's remarriage, whichever occurs first, is a provision specifying a lump sum, even though the entire sum may never have to be paid.[6] On the other hand, where the husband is required to pay a percentage of his net income for a period of less than ten years, the payments are not installments of a principal sum, because no principal sum is specified in the decree.[7]

(3) The payments must be received by the wife subsequent to the decree.

This provision means only what it says, but some taxpayers have nevertheless misunderstood it. It is not necessary that the agreement provide only for payments beginning after the decree: if the obligation to make the payments otherwise qualifies, it may be an obligation to make payments beginning upon the date of the agreement and continuing after the decree. What this provision does mean is

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4 Steinel v. Commissioner, 10 T. C. 409 (1948).

5 Casey v. Commissioner, 12 T. C. 224 (1949); accord: Brandt v. Commissioner, 9 T. C. M. 1151 (1950).

6 Estate of Orsatti v. Commissioner, 12 T. C. 188 (1949); accord: Fleming v. Commissioner, 14 T. C. 1308 (1950); Carmichael v. Commissioner, 14 T. C. 1356 (1950); Read v. Commissioner, 10 T. C. M. 399 (1951).

7 Young v. Commissioner, 10 T. C. 724 (1948) (acq.); Lee v. Commissioner, 10 T. C. 834 (1948) (acq.).

that only those payments made after the decree are deductible. For this reason, in cases where it has been agreed that a settlement shall include both a lump sum and periodic payments, it is sometimes possible to provide for payment of the lump sum before the decree (since it is not deductible anyway) in exchange for a postponement of the commencement of the periodic payments until after the decree when they can be deducted.[8]

> (4) The payments must be in discharge of a legal obligation which because of the marital or family relationship is imposed on the husband incident to the divorce or separation.

Payment of a debt to the wife will not become deductible merely because it is incorporated in an agreement which is incident to a divorce.[9] Thus the deduction will not extend to attorneys' fees[10] nor to the repurchase from the wife of property previously transferred to her.[11] It has been held that where a husband made voluntary payments to his divorced wife, the subsequent amendment of the decree to impose retroactively upon him an obligation to make the payments already made does not make the payments previously made deductible, since they were voluntary when made.[12]

> (5) The obligation must be imposed by the decree or a written instrument incident to the divorce or separation.

There has been considerable litigation arising out of the phrase "written instrument incident to such divorce or separation." Neither section 22 (k) nor the Treasury Regulation issued with respect to that section[13] attempts to define the phrase, although the regulation does provide one example indicating that an ante-nuptial agreement providing for the wife's support for life is not "incident to" a divorce later obtained by the parties. In general, it is apparently sufficient for the purposes of section 22 (k) that the agreement be made in contemplation of a divorce which is at least reasonably probable and that it be intended to discharge an obligation of the husband which would otherwise be enforced by the decree.[14] Where an agreement is made

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8 Such a provision may however affect the liability for gift tax, if the amounts are large enough. This problem is discussed below at page 39 *et seq.*

9 U. S. Treas. Reg. 111, § 29.22 (k) -1.

10 I. T. 3856, 1947-1 Cum. Bull. 23.

11 DuBane, 10 T. C. 992 (1948).

12 Van Vlaanderen v. Commissioner, 175 F. 2d 389 (3rd. Cir. 1949).

13 U. S. Treas. Reg. 111, § 29.22 (k)-1 (1948).

14 Zilmer v. Commissioner, 16 T. C. 365 (1951) (acq.), where the parties had discussed divorce at the time of the agreement. But cf. Miller v. Commissioner, 16 T. C. 1010 (1951), where the husband knew of the wife's intention to seek a divorce but there was no definite understanding to that effect. This problem is avoided if the decree orders compliance with an existing agreement. Neeman v. Commissioner, 13 T. C. 397 (1949).

for the purpose of fixing the rights of the parties arising out of divorce litigation which is actually pending or about to be filed, a common practice is to condition the agreement expressly on the entry of a decree. Such an agreement is clearly "incident to" the divorce. But it is not essential that the agreement be specifically conditioned on the decree, if the circumstances otherwise indicate that divorce was contemplated and that the parties intended that the agreement satisfy the husband's obligation to support his divorced wife.[15] And where this is not practicable, as where the agreement is made at the time of a voluntary separation, the usual practice is to provide that if a divorce shall ever be obtained by either of the parties while the agreement is in effect, the agreement shall be incorporated in the decree. The latter type of provision may also be used where the local law with respect to collusion makes the former provision of doubtful propriety. Where the payments are actually made pursuant to an agreement made after the decree, or pursuant to a modification, after the decree, of a former agreement incident to the divorce, a question arises as to whether the later agreement is itself incident to the divorce. Where the later agreement was made in consideration of the wife's agreement not to contest the validity of an existing decree or where the later agreement is merely voluntary[16] the payments under it have been held not deductible. Whether such an agreement can be held to be incident to the divorce may depend on whether the court has retained jurisdiction to modify its decree. Thus where the original decree was amended to terminate its alimony provisions when the parties had entered into an agreement embodying provisions in lieu thereof, it was held that the agreement was incident to the divorce,[17] but the result is otherwise where the court has retained no jurisdiction to modify its decree.[18] While the point has not been decided, it seems probable that, if the court has retained jurisdiction, and if the agreement is in settlement of the wife's contention that the court should increase the allowance made to her, the agreement is incident to the divorce.

> (6) The payments which are deductible may not include any part which the terms of the decree or instrument fix as a sum payable for the support of minor children.

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15 Neeman v. Commissioner, *supra* note 14; Brady v. Commissioner, 10 T. C. 1192 (1948) (acq.); Johnson v. Commissioner, 10 T. C. 647 (1948) (acq.).

16 Cox v. Commissioner, 176 F. 2d 226 (3rd. Cir. 1949); Alboum v. Commissioner, 10 T. C. M. 300 (1951); Dauwalter v. Commissioner, 9 T. C. 580 (1947) (taxpayer's appeal to 3rd. Cir. dismissed); Sharp v. Commissioner, 15 T. C. 185 (1950).

17 Smith v. Commissioner, 16 T. C. 639 (1951). *Cf.* Gale v. Commissioner, 191 F. 2d 79 (2d Cir. 1951), where the court held taxable to the wife as periodic payments the amount which was paid her pursuant to an amendment of the original decree retroactively increasing the alimony allowance.

18 Dauwalter v. Commissioner, 9 T. C. 580 (1947) (taxpayer's appeal to 3rd. Cir. dismissed).

The deduction is of course limited to payments to the wife, and payments to or for the benefit of the children are not deductible. However, it is important to note that the deduction is not lost unless the portion for the support of the children is fixed by the terms of the instrument either in an amount of money or in terms of a portion of the payment. Thus if the agreement provides that the husband shall pay $300 out of which one-third shall be for the support of the child, or that he shall pay $200 to the wife for her own support and $100 to her for the support of the child, only $200 of the payment is deductible.[19] If instead, the agreement had merely provided for the payment to the wife of $300 per month for her support and that of the child, the entire $300 would have been taxable to the wife.[20] It might be supposed that with this rule in mind, it would be possible in every case to draw an instrument, if so desired, which would permit deductions for the support of the entire family. Failures have resulted, however, from the husband's reluctance to permit his obligation to remain unaffected by the death or majority of the child, or from the insistence of the wife upon continued support for the children after her remarriage. Thus, in the last example given above, if the agreement had gone on to provide that upon the death or majority of the child the payment should be reduced to $200, or that upon the death or remarriage of the mother the husband should therefore contribute $100 per month to the support of the child, the courts would deduce that a specific designation of $100 for the child had been made by the instrument, and the deductibility of that amount would be sacrificed.[21]

The nearest answer to the problem appears to be in a provision for payments decreasing in amount after a stated interval. For example, suppose that the couple have two children, aged ten and seven. It might be provided that payments should be made of $300 per month for the first ten years, $250 per month for the next five years, and $200 per month thereafter, all payments to terminate upon the death or remarriage of the wife. It will be noted that there is a reduction in the amount of the payment of $50 when the first child is 20 and another $50 when the other is 22 – a reasonable approximation of majority. The payments are unaffected by the death of a child, but the probability of that event is ordinarily not so great as to make this a serious problem. This arrangement does have the disadvantage that if the wife dies or remarries, there is no provision for the

19 Budd v. Commissioner, 7 T. C. 413 (1946), *aff'd*, 177 F. 2d 198 (6th Cir. 1947); Leslie v. Commissioner, 10 T. C. M. 807 (1948); Swallen v. Commissioner, 10 T. C. M. 475 (1951).

20 Moitoret v. Commissioner, 7 T. C. 640 (1946); Newcombe v. Commissioner, 10 T. C. M. 152 (1951).

21 Mandel v. Commissioner, 185 F. 2d 50 (7th Cir. 1950); Fleming v. Comissioner, 14 T. C. 1308 (1950).

children and she must rely for their support on the husband's continuing legal obligation to them. In the event of her death, other arrangements would of course have to be made in any event. Whether a termination of the payments in the event of her remarriage would be a serious obstacle would probably depend primarily on the facts of the case, such as the financial condition of the husband and an estimate of his probable attitude toward the children. Subject to these qualifications, the suggested provision appears to be a legitimate method of providing a full deduction for family support by scaling down the payments according to a very roughly predicted schedule of the declining financial burden of the wife.

It should be noted that special provision is made for cases in which the husband fails to pay the full amount he is obligated to contribute to the support of his wife and children. In such cases the amount actually paid is credited first against the support of the children, and only the excess is credited against the deductible payments to the wife.

THE TEN-YEAR REQUIREMENT

The "ten-year" provisions of section 22 (k) are likely to be the most troublesome when first encountered. To understand these provisions it must first be remembered, as noted above, that payments are not deductible unless they are periodic payments, that a lump sum is not a periodic payment, and that installments on a lump sum are likewise not periodic payments — and hence not deductible — unless they meet the conditions set by these provisions.

The first condition is that the principal sum "may be, or is to be paid within a period ending *more* than ten years from the date of such decree or instrument." Note that the statute says "*more* than." If the last payment is to be made on the tenth anniversary of the date of the decree or instrument, it comes a day too soon and ten years of deductions are lost. Perhaps it should be added that the instrument also should not provide for the payment of "$100,000 in ten equal annual installments the first of which shall be paid upon execution of this agreement." This is of course a *nine*-year agreement.

One further, and less obvious, pitfall may be encountered in measuring the period. It will be noted that the statute says "ten years from the date of such decree or instrument." "Such" undoubtedly refers back to the "decree or instrument" by the terms of which the obligation may be or is to be paid within the specified period. Where the obligation is imposed only by the decree, the date of the decree governs; if it is imposed only by the instrument, the date of the instrument governs. But what if both the decree and the instrument impose the obligation? Or what if the instrument imposes the obligation, but the obligation becomes effective only if a decree is entered? Mr. and Mrs. Blum had such an agreement, which was actually entered into long before the enactment of section 22 (k) but which happened to provide for installment payments the last of which was to be made on a date more than ten years from the date of the instrument and more than ten years from the date the court signed the decree, but less than ten years from the date of the entry of the decree on the journal. Several years of litigation resulted for both husband and wife. The Tax Court held in both cases[22] that since the obligation did not become effective until the decree was entered, the obligation was imposed by the decree and the agreement together and the period ran from the date of the decree, when the obligation finally became binding. The Court of Appeals reversed the decision in the husband's case primarily on the ground that under the Illinois law the "date of the decree" was the date of its signing, but secondarily on the ground that the ten-year period ran from the date of the instrument.[23] In the wife's case, however, the same court elected the second ground exclusively.[24] It may be that the matter is now settled, but it would seem a wise precaution, in cases where the decree is to follow so closely upon the execution of the instrument as to make it practical to do so, to provide in the instrument for a period which will not expire until more than ten years after the actual journal entry.

From what has appeared so far, it might be supposed that a lump-sum payment could be converted into a deductible installment simply by coupling it with smaller installment payments as, for example, by providing for the payment of $75,000, of which $50,000 is to be paid one month after entry of the decree, and the balance is to be paid in annual installments of $2500 per year for ten years thereafter. This device was anticipated, however, by the authors of section 22 (k). It is true that the installments need not be equal in amount. But their inequality may result in a loss of part of the deduction. The section provides that each installment may be deducted only to the extent that it does not exceed ten per cent of the principal sum. Thus in the example given the principal sum is $75,000, the aggregate of all the payments, and only $7500 may be deducted out of the $50,000 paid in the first year. The later payments are of course allowable in full.

There is a further limitation which has been introduced by the courts. The ten per cent limitation applies only where the principal sum is specified. If the agreement provides that the husband shall

22 Harry Blum v. Commissioner, 7 T. C. M. 798 (1948); Tillie Blum v. Commissioner, 10 T. C. 1131 (1948).

23 177 F. 2d 670 (7th Cir. 1949).

24 187 F. 2d 177 (7th Cir. 1951).

pay $200 per month until death or remarriage, and in addition shall pay $5000 forthwith, the ten per cent limitation does not apply. Instead it has been held in such cases that the $5000 payment is a lump-sum payment, separable from the provision for a $200 periodic payment.[25] This principle has already been extended to a somewhat less obvious situation, where the agreement provided for monthly installments for one year and also for monthly periodic payments during the joint lives of the parties.[26] In these cases, the installment payments overlap the periodic payments in the initial period. But suppose they do not: suppose the agreement provides for $200 per month for the first year and $100 per month thereafter. Will the courts hold (a) that this agreement calls for a periodic payment of $100 plus installments on a principal sum of $1200, so that $1200 will be disallowed in the first year, or (b) that it calls for payment of a principal sum of $2400 in the first year, all of which will be disallowed, and deductible periodic payments beginning in the second year, or (c) that the case is merely one of decreasing periodic payments so that no deduction is lost?

In *Fleming v. Commissioner*,[27] the agreement in form provided for $200 per month for five years and $100 per month for the next sixteen years, with provisions for reductions in the event of the death or remarriage of the wife or the death of the child. The Tax Court was able to interpret the agreement as equivalent to one requiring payment of $100 per month for 21 years or until the death of the child, and $100 per month for five years or until the death or remarriage of the wife, with the result that the 21-year payments were disallowed because they were for the support of the child, and the five-year payments were disallowed because they were installments on a lump sum payable in not more than ten years. This case may be cited as authority in support of position (a) in the preceding paragraph. The same result would not necessarily have been reached, however, if the 21-year payments had been payments for the support of the wife, or if instead of the 21-year provision there had been required a payment for the wife's support for an indefinite period until her death or remarriage.

The latter situation was involved in *Carmichael v. Commissioner*,[28] in which the agreement provided for $200 per month for the wife and $50 for the child until $27,000 had been paid (a nine-year period) plus payment of the premiums on an insurance policy on the life of the husband owned by the wife (a periodic payment). The

25 Norton v. Commissioner, 16 T. C. 1216 (1951); Baer v. Commissioner 16 T. C. 1418 (1951).

26 Haag v. Commissioner, 17 T. C. No. 7 (1951).

27 Fleming v. Commissioner, 14 T. C. 1308 (1950).

28 14 T. C. 1356 (1950).

agreement was held separable and the $200 payments (and of course the $50 payments) were disallowed as deductions.[29]

The combination which has not been covered by the cases is that of a principal sum payable in more than ten years with a principal sum payable in less than ten years, either in a short series of payments or in a single lump sum. It seems reasonably certain that if an agreement should provide, for example, for the payment of $12,000 on entry of the decree and $500 per month at monthly intervals thereafter for 20 years, the courts would consider the payments separable and deny the deduction of the $12,000. On the other hand, if the agreement provided for payment of the same aggregate amount ($132,000) in payments of $700 per month for the first five years and $500 per month for the next fifteen years, it seems quite possible that the courts might reach the opposite result. Pending further clarification of the law on this point, it therefore seems desirable, if the maximum deduction for the husband is sought, to spread any installments of a lump sum over as long a period as can be negotiated and combine these payments with a series of installments extending over more than ten years, as in the last example. Such an arrangement is at least in a position to obtain the benefit of favorable authorities when and if such decisions are made.

In connection with the ten per cent limitation, it should be noted that special provision is made for payments by the husband in advance. For example, if it is desired to have the wife receive $100,000 at once as well as an additional $100,000 over a more than ten-year period, it will not do to provide for payment of $200,000 over the same period and let the husband advance $100,000 of the total amount currently. The statute provides that even though a payment may be properly allocable to a later year it is to be considered as an installment payment for the year in which it is received. Thus in the example given, only $20,000 (ten per cent of the aggregate amount) would be deductible in the first year.

Insurance Premiums

One further matter which needs to be considered in connection with section 22 (k) is the handling of insurance premiums, payment of which may be one form of indirect payment to the wife. It would seem reasonably clear that if the wife owns a policy, payable to herself, whether on her own life or that of her husband or a third person, and if the husband agrees to pay the premiums, the payment is a periodic

29 The same result was reached in Read v. Commissioner, 10 T. C. M. 399 (1951) again involving insurance premiums plus cash payments for a less than ten-year period.

payment to her and is includible in her income and deductible from his.[30] The problem becomes more difficult as the benefit to the wife becomes less direct. Where the policies are provided merely as security for the direct payments, the premiums are not deductible.[31] But where the policies were assigned to the wife, the amounts paid on the premiums by the husband are to be included in the wife's income.[32] In one case where taxability to the wife of other payments was involved, the Commissioner made no assertion that the payment of premiums by the husband should be taxable to the wife where the policy, though not assigned to the wife, named her irrevocably as beneficiary until she should die or remarry.[33] But the Bureau appears to be following administratively a practice of taxing the premiums to the wife where she is irrevocably named as primary beneficiary (but not where she is the contingent beneficiary) regardless of whether the policies are assigned. And deduction of premiums has been allowed to the husband where the policies were delivered to a trustee pursuant to the agreement.[34]

The case of *Boies C. Hart v Commissioner*[35] produced a surprisingly favorable result from the husband's point of view. In that case the decree of divorce required the husband to pay 38.5 per cent of his income to or for his wife, but provided further that there should be credited against that amount payments of premiums on insurance held in an insurance trust for the benefit of the wife and the child. The distribution provisions of the trust provided for payment of two-thirds of the income to the wife, the other third going to the settlor's descendants, or if there were none to other persons. The wife had no interest in principal, which was distributable only after her death. The Tax Court nevertheless held the payments deductible because they were charged against obligations imposed for the wife's benefit. Other factors, such as the fact that the wife could require a reduction in the amount of the insurance if the cash payments to her fell below a specified amount, may serve to distinguish the case, and it would probably be unsafe to construct a separation agreement around it. It is interesting to note, however, that Mr. Hart did succeed in deducting the cost of providing an estate which would ultimately pass to his descendants, an opportunity rarely achieved by the taxpayer.

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30 I. T. 4001, 1950-1 Cum. Bull. 27.

31 Blumenthal v. Commissioner, 183 F. 2d 15 (3rd. Cir. 1950); Carmichael v. Commissioner, 14 T. C. 1356 (1950); Gardner v. Commissioner, 14 T. C. 1445 (1950); Taylor v. Commissioner, 16 T. C. 376 (1951).

32 Stewart v. Commissioner, 9 T. C. 195 (1947).

33 Hesse v. Commissioner, 7 T. C. 700 (1946).

34 Mandel v. Commissioner, 8 T. C. M. 445 (1949), *aff'd as to other issues*, 185 F. 2d 50 (7th Cir. 1950).

35 11 T. C. 16 (1948).

SECTION 171

Income taxes in connection with divorce settlements are affected not only by sections 22 (k) and 23 (n), but also by section 171. The latter section, however, deals exclusively with the income from trusts. Like sections 22 (k) and 23 (n), it was added to the Code by the Revenue Act of 1942.

It will be remembered that, in general, trusts are taxed like individuals, with certain exceptions, chief of which is that a trust may deduct, under section 162, income distributed or distributable to the beneficiary, such income being taxed to the beneficiary. Ordinarily the income is not taxed to the grantor of the trust, but there are exceptions. First, under section 166, the income is taxable to the grantor (even though actually distributed to some one else) where the grantor has retained the right to revest title to the corpus in himself. Second, under section 167, the same rule applies where the income may be recovered by the grantor, or is applied on insurance on his life. Finally, it had been held, prior to 1942, that the income of a trust established to pay alimony was taxable to the grantor under section 22 (a), which is the section of the Code generally defining gross income, on the ground that the situation was substantially equivalent to one in which the grantor himself received the income and paid it over to his wife.[36]

Section 171 is designed to shift the burden of the tax on this income from the husband to the wife, just as sections 22 (k) and 23 (n) shift the burden of the tax on payments made directly by the husband. It provides as follows:

> (a) Inclusion in Gross Income.—There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance the amount of the income of any trust which such wife is entitled to receive and which, except for the provisions of this section, would be includible in the gross income of her husband, and such amount shall not, despite section 166, section 167, or any other provision of this chapter, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.
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> (b) Wife Considered a Beneficiary.—For the purposes of computing the net income of the estate or trust and the net

[36] Douglas v. Willcuts, 296 U. S. 1 (1935).

> income of the wife described in section 22 (k) or subsection (a) of this section, such wife shall be considered as the beneficiary specified in this supplement. A periodic payment under section 22 (k) to any part of which the provisions of this supplement are applicable shall be included in the gross income of the beneficiary in the taxable year in which under this supplement such part is required to be included.[37]

It should be noted that while section 171 deals exclusively with trusts, section 22 (k) also deals with trusts and for this reason discussion of the provisions of section 22 (k) dealing with the income "attributable to property transferred" has been postponed to this point. Section 22 (k) refers in its first sentence to "periodic payments . . . attributable to property transferred (in trust or otherwise) in discharge of a legal obligation which," etc. The last sentence of section 22 (k) is a cross-reference to section 171 (b) "in cases where such periodic payments are attributable to property of an estate or property held in trust." At first glance the two provisions appear to overlap in trust cases, but actually they do not. Section 22 (k) applies to cases in which the property is transferred in discharge of a legal obligation imposed by the decree or by an instrument incident to a divorce or legal separation. It would not apply, for example, to a case in which the property had been transferred in a revocable trust not incident to a divorce, even though the parties were later divorced. In such a case, the income would be taxable to the husband if it were not for section 171.[38] Furthermore, section 171 applies only to cases where the income would otherwise be taxable to the husband, so that it does not apply to any case where the husband already receives the benefits of section 22 (k). Of course it would hardly matter which of the two sections applied (so long as one of them did) if it were not for the fact that the two sections differ in some other respects. First, section 22 (k) makes taxable to the wife all periodic payments attributable to the property whether they are paid out of income or out of principal. Thus if the husband creates a trust meeting the requirements of section 22 (k) and providing that the trust shall pay to the wife an annuity of $5000 payable out of corpus if the income is insufficient, the wife is taxable on the $5000 she receives, even if the income of the trust is only $3000 and the balance is paid out of corpus.[39] If the trust had failed to meet the requirements of section 22 (k) but had been governed by section 171, the wife would have been

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37 The Revenue Act of 1943 added section 167 (c) which provides that income of a trust which may be applied for the support of those the grantor is obligated to support is not taxable to him unless actually so applied. This does not, of course, affect the application of section 167 to most alimony trusts, so that even if section 167 (c) had been in the law prior to 1942, it would still have been necessary to enact section 171 as a companion to sections 22 (k) and 23 (n).

38 U. S. Treas. Reg. 111, § 29.171-1.

39 U. S. Treas. Reg. 111, §§ 29.22 (k) -1 (b) and 29.171-2.

taxable on only the $3000 paid out of income.[40] There is probably an additional difference between the two sections in the fact that the installment provisions of section 22 (k) including the ten-year limitation, would seem to be applicable to payments by a trust which otherwise satisfies the requirements of section 22 (k); section 171, on the other hand, does not contain these limitations.

It has been generally assumed in this discussion that the husband is in a higher tax bracket than the wife and that for that reason it is desirable to shift the tax to her. It should be noted, however, that in the trust situation the same result does not always follow. Where the payments to the wife to be made largely out of the corpus of property transferred, and only partly out of income, shifting the burden to the wife increases the aggregate tax burden of the couple, since the wife is taxable on the corpus payments as well as the income payments, while the husband may exclude the income but apparently does not acquire a right to deduct the corpus. The law is not entirely clear on the latter point but section 23 (u) says that the husband is not entitled to a deduction where "the amount of any such payment is, under section 22 (k) or section 171, stated not to be includible in such husband's gross income." Section 22 (k) "states" that payments attributable to property transferred are not includible by the husband. The fact that the corpus payments would not in any event be includible by the husband appears irrelevant, since section 23 (u) does not say "the amount which is, *by virtue of* section 22 (k) or section 171, not includible." Thus it is stated in the regulations that where the husband, in order to meet an alimony obligation of $500 a month, purchases an annuity contract paying her such amount, "the full $500 received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him."[41] The inclusion in the wife's income of that part of the payment which actually represents income is matched by the exclusion of the same part from the husband's income, but the inclusion in her income of the part of the payment representing the return of the principal is not matched by any corresponding tax benefit by the husband. The Treasury, anticipating attempts to circumvent this provision, stated in the regulation that if the husband transfers property to his wife so that she herself may buy the annuity (hoping to avoid the tax on the part of the payment representing corpus) the case will be treated as if the husband had himself made the investment.[42] It might be possible to solve this problem by having the husband agree to make periodic payments to the wife for life and to buy an annuity payable to himself to secure his ability to make the payments. Here, even if it can successfully be con-

[40] U. S. Treas. Reg. 111, § 29.171-1.

[41] U. S. Treas. Reg. 111, § 29.22 (k) -1.

[42] ibid.

tended that the payment is "attributable to" the property, (the annuity) it seems impossible to hold that the property has been transferred. The husband should therefore be entitled to deduct the full amount of the payments made.

ESTATE TAX

The Estate Tax is not in most cases of as great importance to the parties as the income tax and the gift tax, since its imposition is deferred and incidental. The few problems which have arisen have been in connection with the treatment of insurance and of indebtedness for alimony claims.

Section 812 (b) of the Code provides in part that there shall be allowed as deductions the allowed claims against the estate with certain limitations and exceptions, including the following:

> The deduction herein allowed in the case of claims against the estate . . . shall, when founded upon a promise or agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth . . . .
>
> For the purposes of this subchapter, a relinquishment or promised relinquishment of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration "in money or money's worth."

In view of the language of the final sentence inserted in 1932,[43] it is now settled that a claim under a separation agreement is not a deductible debt[44] where the consideration was the release of marital rights in the property of the decedent. But a claim based on unpaid alimony under a decree of divorce is deductible.[45] It appeared, however, that the distinction rested not upon the difference between rights in property and the right to support, but rather on the difference between claims founded on the decree and claims which, in the words of section 812 (b) are "founded upon a promise or agreement."[46] It was the view of the court in these decisions that the release of support rights was no more adequate consideration than the release of dower. The Bureau, however, then took a position more favorable to the

43 Revenue Act of 1932, §804.

44 Sheets v. Commissioner, 95 F. 2d 727 (8th Cir. 1938).

45 Commissioner v. State Street Trust Co., 128 F. 2d 618 (1st. Cir. 1942).

46 Commissioner v. Maresi, 156 F. 2nd. 929 (2d Cir. 1946), citing Meyer's Estate v. Commissioner, 110 F. 2d 367 (2d Cir. 1940), *Cert. denied,* 310 U. S. 651 (1940); Helvering v. United States Trust Co., 111 F. 2d 576 (2d Cir. 1940); Adriance v. Higgins, 113 F. 2d 1013 (2d Cir. 1940).

taxpayer and issued E. T. 19[47] a ruling dealing primarily with gift tax[48] but also announcing "the view of the Bureau that the surrender of support rights is not one of the 'other marital rights' referred to in the section [812 (b)]. The cases of *Meyer's Estate v. Helvering* (C. C. A. 2, 1940) (110 F. 2d 367, *certiorari denied,* 310 U. S. 651) and *Helvering v. United States Trust Co. et. al.* (C.C.A. 2, 1940) (111 F. 2d 576) will no longer be followed to the extent that they hold that the right of a divorced wife to support from a former husband during the joint lives of the parties is a marital right in his property or estate."

The question whether the claim is "founded on an agreement" or on the decree of course remains to be decided. It has been held in several cases that if the agreement is incorporated in the decree, at least if the divorce court could have rejected the agreement had it desired, the obligation is founded on the decree.[49] Further definition is probably required on this point. The recent gift tax decision by the Supreme Court in *Harris v. Commissioner,*[50] dealing with the same issue, has not substantially clarified it.

With respect to life insurance, it might be expected that the decisions would follow the pattern of the cases discussed above. Section 811 (g) requires inclusion in the estate of insurance payable to the estate, or if payable to others, if the decedent either retained incidents of ownership at his death, or if he paid premiums on it, "in proportion that the amount so paid by the decedent bears to the total premiums paid." No exception is made for insurance directed to discharge obligations incurred in connection with a divorce. The Board of Tax Appeals held in one case[51] that where insurance is used to secure the payment of alimony, the insurance must be included, but a deduction can be taken for the debt which it discharged. Where the policy is used directly, as by an agreement to pay premiums on an existing policy irrevocably payable to the wife, a different result may be reached, however, since the Court of Appeals for the Second Circuit has held that such a policy is not to be considered payable to the estate, and that the agreement effectively divests the insured of the incidents of ownership.[52] This leaves the insurance taxable only to the extent of the proportion of premiums paid by the insured, even

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47 1946-2 Cum. Bull. 166.

48 The litigation with respect to E. T. 19 in its gift tax aspects will be discussed below.

49 Commissioner v. Maresi, 156 F. 2d 929 (2d Cir. 1946); Fleming v. Yoke, 53 F. Supp. 552 (N. D. W. Va. 1944), *aff'd,* Yoke v. Fleming, 145 F. 2d 472 (4th Cir. 1944); Swink v. Commissioner, 4 T. C. M. 518 (1945), *aff'd,* Commissioner v. Swink, 155 F. 2d 722 (4th Cir. 1946).

50 340 U. S. 106 (1950). This decision is discussed at greater length at pp. 40 - 44 *infra.*

51 Estate of Mason v. Commissioner, 44 B. T. A. 813 (1941).

52 Cowles v. U. S., 152 F. 2d 212 (2d Cir. 1945).

though the circumstances are such that the payment to the divorced wife, if made with assets of the estate would not have been deductible. If, therefore, the agreement provides for cash payments to the wife, who in turn pays the premiums or not as she sees fit, it should be possible to avoid estate tax on the insurance.

GIFT TAX

The imposition of gift tax liability in connection with divorce settlements is a comparatively recent development. It now seems clearly established that in a prenuptial agreement, the release by the wife of marital rights of support and dower is not "adequate and full consideration"[53] and that a recital of consideration of such a nature does not affect the status of a transfer as a gift.[54] It was until recently supposed that for gift tax purposes this rule was confined to prenuptial cases and did not apply to divorce and separation settlements, and the Tax Court so held in 1943, significance being attached to the fact that the gift tax provisions do not, like section 812(b) of the Estate Tax Law, provide expressly that the release of marital rights shall not be considered as a consideration in money or money's worth.[55] In 1945 the Tax Court elected to follow its previous decision, four judges dissenting, in *Converse v. Commissioner*.[56] The Treasury announced its non-acquiescence,[57] and shortly thereafter issued a ruling,[58] announcing its position to be that a transfer in consideration for the wife's release of "support" rights in connection with a divorce or separation settlement did not constitute a gift but that the release of "property or inheritance rights" is not consideration for the transfer, which is therefore a gift; and further, that to the extent that the value of the payment made exceeded the value of the support rights (actuarial

[53] § 1002.

[54] U. S. Treas. Reg. 108, §86.8; U. S. Treas. Reg. 79, Art. 8 (1936). This position was sustained by the Supreme Court in Commissioner v. Wemyss, 324 U. S. 303 (1945); and Merrill v. Fahs, 324 U. S. 308 (1945).

[55] Jones v. Commissioner, 1 T. C. 1207 (1943); Geary v. Commissioner, 2 T. C. M. 202 (1943). The Treasury announced its non-acquiescence in the *Jones* decision (1943 Cum. Bull. 34) but dismissed its petition for review. The court had previously, however, in the same year, held that a payment, pursuant to a separation agreement, in consideration for the release of obligations under a prenuptial contract was a gift. Lasker v. Commissioner, 1 T. C. 208 (1942), *rev'd*, 138 F. 2d 989 (7th Cir. 1943). Yet as recently as 1942 the Treasury had successfully contended that a transfer of property pursuant to a divorce decree resulted in the realization of capital gain by the husband. Commissioner v. Halliwell, 131 F. 2d 642 (2d Cir. 1942); Commissioner v. Mesta, 123 F. 2d 986 (1941). These cases may still be applicable in situations where the gift tax does not apply.

[56] 5 T. C. 1014 (1945); *accord*, Mitchell v. Commissioner, 6 T. C. 159 (1946).

[57] 1946-1 Cum. Bull. 5.

[58] E. T. 19, 1946-2 Cum. Bull. 166.

standards being taken into account) the transfer was taxable.

In the meantime, the Tax Court reached the same result in *Lahti v. Commissioner*,[59] and the following year the *Converse* case was affirmed on appeal.[60] The court discussed E. T. 19 in *Judson v. Commissioner*,[61] but found it unnecessary to determine whether it correctly stated the law, holding that since the Commissioner had not shown the allocation of the payment between the support rights and the maintenance rights, and since the release of support rights provided adequate consideration, no gift tax was payable. In the same year, in *Thompson v. Commissioner*,[62] the court held that a transfer by the wife to the husband in a separation agreement incorporated in a divorce decree, in consideration of the release of inheritance rights only, was a gift. The court indicated in this discussion that its decision rested on the fact that there was no obligation of support which the divorce court could have forced upon the transferor. The same principle was applied in *Estate of Barnard v. Commissioner*,[63] where two payments were made, one of which was incorporated in the decree, the court holding that there was consideration for this payment but not for the other since the consideration had already been received. The decision was later reversed, however, the Court of Appeals holding both payments taxable.[64]

In 1948, six more cases involving E. T. 19 reached the Tax Court. *Hooker v. Commissioner*[65] involved transfers to a trust for the children, the court holding that the value of the assets transferred in excess of the value of the income provided for the children during their minorities (when the taxpayer had a legal obligation to support them) was a gift. While the court declined to apply a part of the holding of the *Converse* case which applied to payments for the support of minor children, it stated that payments to children fell into the same class as prenuptial transfers to the wife and the circumstances in such cases could not, as in the case of payments to the wife incident to divorce, be presumed to "negative the presence of a donative intent." The Court of Appeals affirmed.[66] The Tax Court continued, however, in four more cases, to maintain its position that where the transfer was ordered by the divorce court it was not a gift.[67] Two of these cases, *McLean v.*

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59 6 T. C. 7 (1946).

60 163 F. 2d 131 (2d Cir. 1947).

61 6 T. C. M. 242 (1947).

62 6 T. C. M. 822 (1947).

63 9 T. C. 61 (1947).

64 Commissioner v. Estate of Barnard, 176 F. 2d 233 (2d Cir. 1949).

65 10 T. C. 388 (1948).

66 174 F. 2d 863 (5th Cir. 1949).

67 Estate of Moore v. Commissioner, 10 T. C. 393 (1948) (non-acq.); Harris v. Commissioner, 10 T. C. 741 (1948); McLean v. Commissioner, 11 T. C. 543 (1948) (non-acq.); Taurog v. Commissioner, 11 T. C. 1016 (1948) (involving a

Commissioner and *Harris v. Commissioner,* are of particular interest. In the *McLean* case, the taxpayer agreed to make periodic payments to his former wife until she remarried, and after her remarriage, to make further periodic payments until 1955. The wife released both support rights and property claims. The Commissioner contended that the computed value of the payments agreed to be made after remarriage, when the right to support would no longer exist, was a gift under E. T. 19. The court held first that whether some payments might be made before or after marriage was irrelevant, the question being whether there was consideration for whatever payment was made; and second that the release of the wife's claims constituted full and adequate consideration in money or money's worth, the situation differing from the prenuptial cases in that the wife in the divorce situation has an existing and enforceable claim to release, adding:

> For reasons not clear to us, E. T. 19 excepts support and maintenance from marital rights the release of which does not constitute full and adequate consideration. We deem the ruling invalid in so far as it does not also except transfers made to settle presently enforceable claims.[68]

In the *Harris* case, the husband and wife had made a settlement involving reciprocal transfers of property, gift tax being asserted against the excess received by the husband. The agreement was conditioned on the granting of a divorce, but was to survive the decree. The Tax Court ruled for the taxpayer on the ground that the payment was founded on the decree.

The Treasury filed petitions for review in both the *McLean* and *Harris* cases, but prosecuted only that in the *Harris* case, which of course did not involve support payments. The Court of Appeals held[69] that the distinction between payments founded on an agreement and payments founded on a decree, previously applied to the estate tax problem in the *Maresi case,*[70] was applicable to the gift tax as well, but reversed the Tax Court on the ground that since the agreement, which had been approved by the divorce court, provided that it should survive the decree, the transfer was founded as much on the agreement as on the decree, and was subject to tax. It distinguished the *Converse* case[71] on the same ground.

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division of community property); Harding v. Commissioner, 11 T. C. 1051 (1948) (involving a lump sum plus periodic payments, all of which were in consideration of the release of all support and property rights. Although the agreement was to be binding regardless of divorce, a divorce was later obtained. The Bureau announced its acquiescence in this decision).

68 11 T. C. at 549.

69 178 F. 2d 861.

70 Commissioner v. Maresi, 156 F. 2d 929 (2d Cir. 1946).

71 5 T. C. 1014 (1945).

The following year the Supreme Court reversed this decision of the Court of Appeals holding that the payment was "founded on the decree" because it was enforced by it, and expressly approved the *Maresi* and *Converse* cases, which it said were not distinguishable.[72]

It is not easy, however, to distill from the decision a reliable test of whether any given payment is in fact "based on the decree." The majority opinion directs attention to the fact that the settlement was to become effective only in the event a divorce should be decreed and noted further that the agreement provided that it was to be submitted to the divorce court "for its approval." After these observations, Mr. Justice Douglas states:

> If the agreement had stopped there and were in fact submitted to the court, it is clear that the gift tax would not be applicable. That arrangement would not be a "promise or agreement" in the statutory sense. It would be wholly conditional upon the entry of the decree; the divorce court might or might not accept the provisions of the arrangement as the measure of the respective obligations; it might indeed add to or subtract from them. The decree, not the arrangement submitted to the court, would fix the rights and obligations of the parties. That was the theory of *Commissioner v. Maresi*, 156 F. 2d 929 [46-1 USTC Para. 10,276], and we think it sound.

Later in the opinion it is stated:

> Yet without the decree there would be no enforceable, existing agreement whether the settlement was litigated or unlitigated. Both required the approval of the court before an obligation arises. The happenstance that the divorce court might approve the entire settlement, or modify it in unsubstantial details, or work out material changes seems to us unimportant. In each case it is the decree that creates the rights and the duties; and a decree is not a "promise or agreement" in any sense—popular or statutory.

The court next goes on to consider the argument advanced by the government based on the provision of the agreement that its terms were to survive the decree of divorce. The court disregards this circumstance largely on the ground that the court is concerned with the source of the rights and not with the manner in which the rights at some distant time may be enforced. At the conclusion of the opinion, it is stated that the Treasury regulations considering gifts where "a promise or agreement" is involved are not intended to apply to situations of this kind.

There has been only one decision of the Tax Court since the *Harris* case involving this problem. In *McMurtry v. Commissioner*[73]

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[72] 340 U. S. 106 (1950).
[73] 16 T. C. 168 (1951).

it appeared that the decree had "approved" the divorce, but that the agreement was neither contingent upon nor enforced by the decree. The agreement provided for the creation of trusts to make periodic payments to the wife until her death or remarriage, a child receiving the balance of the income prior to the wife's remarriage, and all the income thereafter, during the child's life. The court distinguished the *Harris* case on its facts, pointing out that the agreement created enforceable rights without any further action by the court, and held the transfers taxable. At the same time, it held that only that part of the amounts transferred was subject to tax as exceeded the actuarial value of the support rights, thus reversing its position in the *McLean* case[74] on the authority of the Court of Appeals' decision in the *Barnard* case.[75]

If the state of the law at this point may seem to the practicing lawyer to be confused, it is probably because that is the fact. The cases have been discussed above chronologically for the very reason that the application of the gift tax in this situation is a recent development which has not yet reached a stage where any very certain principles have evolved. A few guideposts, however, can be pointed out. First, the infrequency of Supreme Court decisions on any single point of law usually means that a large body of lower court decisions will be built upon the holdings, dicta and necessary and unnecessary implications of any Supreme Court pronouncement, and the *Harris* case will be no exception. Second, it now appears that the doctrine of the older Tax Court decisions that a settlement incident to divorce is essentially different (from the point of view of the existence of "consideration") from a prenuptial agreement is now obsolete; the issue now depends upon whether the obligation is founded on the decree or on the agreement. The key to the determination of this question, however, is somewhat harder to discover. In the *Harris* case, the agreement (a) was conditioned on the divorce and (b) was enforced by the decree, but (c) survived entry of the decree.

It is to be noted that Mr. Justice Douglas emphasized the fact that the settlement provisions were subject to approval of the court and might be modified by the court. A doubtful case might be one in which a settlement agreement was made which was to become effective only upon the entry of a decree of divorce and where the decree of divorce made no reference to the settlement agreement. Such a situation might be distinguishable even though the court had the power to upset the settlement agreement or make different provisions than provided in the agreement, since it might be argued that the decree was not the source of the obligation in a case where the decree did not order compliance with the agreement. As a practical matter, in such a situation

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74 11 T. C. 543 (1948) (non-acq.).

75 176 F. 2d 233 (2d Cir. 1949).

there would be nothing in the divorce decree to indicate what the obligation was.

Bearing in mind that in the *Harris* case the divorce court apparently incorporated some of the provisions of the settlement agreement in its decree, (although this factor was not emphasized) a question arises as to whether it would be safe to have the court specifically approve the agreement and order the parties to comply with it. This may be a reasonably safe course if the majority opinion is to be followed, although some doubt may be cast upon this in the dissent of Justice Frankfurter. It was noted in the dissenting opinion that one of the transfers required by the agreement was not incorporated in the divorce decree and the Justice stated in the footnote ". . . and therefore is enforceable presumably only under the contract." This point of view Justice Frankfurter describes as the narrower ground but states in the footnote that "on the broader ground apparently employed [in the majority opinion] no gift tax is due." Thus the dissenting opinion might be said to cast some doubt on just what the majority opinion held in this respect.

Third, if it is established that the inter-relation of the agreement and the decree is such as to give rise to potential gift tax liability, the *McMurtry* case indicates that payments for support remain free of tax and it is only the payments in consideration of the release of property rights that are taxable; further, that the two may be separated by the application of actuarial standards. In these respects the Bureau has finally, after five years of litigation, persuaded the courts to adopt E. T. 19.

Finally, it is apparently still true, as in the *Hooker*[76] case, that the transfers for children's benefit are treated in the same manner as those for the wife, since the income for the child in the *McMurtry* case was held to be non-taxable to the extent that it provided for her support during minority. It seems possible, however, that this point may be subject to future attack by the Bureau.

Recommendations

The principal task of the lawyer who gives tax advice in connection with a matter of this kind is not to decide what tax may be payable on a given set of facts, but rather to devise an arrangement which, while accomplishing the general purposes of the parties, will be least likely to produce unforeseen and unfavorable tax results. If it appears that all that is needed by the parties is simple alimony for the period until the wife dies or remarries, the amounts to be paid can be

76 10 T. C. 388 (1948).

established on the assumption that the wife will pay the income tax and that no gift tax will be payable.

But what of the more complicated settlement? It may be taken as reasonably clear that to the extent that the obligation is created in the decree alone, there being no agreement, there will be no gift tax liability under the *Harris* case; but since the possibilities for variety are limited if the matter is left to the decree alone, any more complicated plan will have to be based, at least initially, on an agreement. In order to avoid gift tax liability, it would of course be desirable to have the agreement conditioned upon the decree; if it is also provided that the agreement is to be approved by the court, the necessary disclosure would seem to dispose of any possibility of a later contention that the form of the agreement made the divorce collusive. If, as is sometimes the case where there may be some delay before the divorce is granted, or where the parties want to avoid having one of them attempt to defeat the settlement in the divorce court, it is desired to have the agreement binding in any event, it would nevertheless be advisable to provide that the court should approve the agreement, incorporate it in the decree, and order compliance with it. In order to avoid any question concerning the validity of the incorporation it is probably also the better practice to have the decree incorporate the operative provisions of the agreement in terms, rather than by reference to the agreement. Obviously, in any case where the *Harris* case is to be relied on, the transfer in question should not be made until after the decree.

So long as the *Harris* case continues to stand for what it appears to say, this should solve the gift tax problem. Bearing in mind, however, that the Treasury in E. T. 19 proposed a set of principles which were not dependent on whether the obligation was created by the decree or by the instrument, it is advisable, particularly if large amounts are involved, to assume that future inroads may be made on the protection afforded by the Harris case.[77] This suggests that periodic payments to be continued after remarriage should be avoided wherever possible. If a separate consideration were given for the release of the property rights, and if it were expressly stipulated that periodic payments to the wife for life were to be made in consideration only of her release of her right to support prior to remarriage, it is at least possible that the allocation would be sustained. The *McMurtry* case, while it overrules the refusal of the *McLean* case to recognize a difference between support rights and property rights, does not necessarily require that the determination of the allocation of the payments by the husband between support rights and property rights correspond to the relative values of the payments to be made before remarriage and

[77] It has already been attacked by commentators with considerable persuasiveness. Taylor and Swartz, *Tax Aspects of Marital Property Agreements*, 7 TAX L. REV. 19 (1951).

the payments to be made afterward, since it adopted that standard only for lack of any other in the evidence.

It should be noted that in cases where all payments are to be in the form of principal sums, whether or not payable in installments, allocation might similarly be made by providing for a separate payment for the release of each of the two rights. The allocation would have to be reasonable, but if it were it might help to forestall possible litigation. Furthermore, if such an allocation is made, the support payments might be made binding in any event and the property settlement conditioned on the divorce.

It has been pointed out above that it is unwise to use a trust to make payments where corpus will be used for the purpose, since such payments will be subject to income tax on the wife without a corresponding deduction for the husband. In general, it appears that it is better to use the trust as a security device rather than for direct payments, since the foregoing objection is removed and the gift tax problem alleviated. On the other hand, a trust may be a desirable method where corpus is not to be used to make periodic payments and where the gift tax is not a serious objection. Consideration may also be given to the use of a trust qualifying under section 171 rather than 22 (k), although such a trust cannot, of course, have the protection of the *Harris* case against gift tax, not being "founded on the decree."

Without respect to provisions for children, it should be remembered that it is not the intention of the Code to make it easier for a father to transfer his estate to his children merely because he is divorced from their mother. His relationship to them continues as before, and like other fathers he may not, in general, deduct the cost of their upbringing, nor transfer large amounts of capital to them free of gift tax. He is, however, permitted to agree to pay the mother a gross amount for her own support and that of the children and thus shift the tax burden (along with the dependency credits) to the presumably less heavily taxed income of the mother, and if circumstances are such as to make such an arrangement otherwise satisfactory, this is of course a preferable method. It should be noted, however, that if the payments for both purposes are combined in this way, it is not possible to use a provision terminating the payments on remarriage, and a gift tax problem is thus created (depending perhaps, on the vitality of the *Harris* case) if a direct-paying trust is used.

Insurance creates a special problem. Since policies transferred (other than to the insured) for a valuable consideration lose their income tax exemption with respect to payment at maturity,[78] it is probably unwise to transfer policies to the wife until the extent to which divorce is a valuable consideration has been further clarified, even if the gift tax is not a serious obstacle. To have ownership retained

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78 Sec. 22 (b) (2).

by the husband, he agreeing to pay the premiums (perhaps with a trust as guarantor) and to make her the sole beneficiary, is probably satisfactory for income and gift tax purposes, but will probably raise estate tax difficulties. The best arrangement is of course to have the wife take out a new policy on the husband's life and pay the premiums herself out of the income he pays her. If this is impossible, the best solution is probably not to transfer the policies but to divest the husband of the "incidents of ownership" by forbidding him to exercise any of them, the wife again paying the premiums.

A final word should be said about tax indemnity provisions. Such provisions have not yet been at issue in the litigated cases, [79] but it is understood that a number are in effect. It is usually provided by such a provision (assuming that the amount of a series of payments was negotiated on the basis that they would be taxable to the wife) that if any part of the payment should be taxed to the husband (or held not deductible by him) the wife will indemnify him in accordance with a specified formula which also reduces the later payments. Since the parties may be in quite different tax brackets, some problems arise as to the measure of the reduction, and the wife should probably not be required to compensate him to the extent of the entire increase in his tax. A fair arrangement is probably to provide that the husband shall be reimbursed to the extent that the shift of the tax burden back to him reduces the wife's net tax liability below what it would otherwise have been, (but not in excess of the increase in his burden) and which thereafter provides a corresponding reduction in periodic payments. Of course such indemnities must be reciprocal if the agreement includes some payments which are thought to be taxable to the wife and some which are not.

An indemnity clause with respect to the gift tax is of course not practical, since we are dealing there not with a tax unexpectedly shifted to the other party but with a tax the parties did not expect at all, and the disadvantage of one party cannot be set off against the windfall to the other. The same is true of the estate tax.

Income tax indemnity clauses such as the above involve complications in drafting which cannot be covered in a brief review, and the unraveling of them, if they ever become operative, will probably be even more complicated. Nevertheless their use will probably continue by those who draft settlements with any awareness of the fact that they are dealing with shifting authorities in an unsettled aspect of a complicated and uncertain subject.

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79 A provision in the divorce decree that the wife should pay the taxes was held without significance in determining tax liability in Casey v. Commissioner, 12 T. C. 224. And the settlement considered in the *McLean* case (p. 33, *supra*) contained a provision reducing the periodic payments to a specified lower figure if they were held not deductible by the husband.